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PRAGUE FOR POLITICAL AND ECONOMIC OFFICERS

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TAGS: PREL EFIN ENRG HU
SUBJECT: CONFIDENT VERES AGAINST OMV-MOL MERGER; BULLISH ON

REFORMS

REF: A. A) BUDAPEST 1137
¶B. B) BUDAPEST 72

Classified By: Political-Economic Counselor Eric Gaudiosi for reason 1.
4 (d).

¶1. (U) This message contains an action request. See paragraph 4.

2.(C) Summary: In a relaxed lunch meeting with Ambassador Foley, Finance Minister Janos Veres and State Secretary Almos Kovacs frankly discussed their desire to sidetrack the OMV/MOL merger and their interest in developing a system to protect strategic industries. Veres described a GOH basking in EU approval of Hungary's deficit reduction measures, and he maintains that the PM has been sobered by low poll numbers and strengthened his position within his party to see the reforms through. Despite recent higher inflation figures, Veres sees a full recovery by 2009. End Summary.

Looking to Block the OMV/MOL Merger

3.(C) Veres called concerns about increasing Russian control over energy supplies in Central Europe "music to my ears." Despite this, he discounted a MOL official's suspicion of a Gazprom connection with Megdet Rahimkulov, because Rahimkulov supported Gazprom's prior CEO and has an openly hostile relationship with their new leader. In fact, if one rumor Veres mentioned comes true, then it is, in fact, a U.S. major that ultimately wants to buy OMV and MOL shared assets, because it would give them a near-monopoly in refining and distribution in five countries. In his travels to Austria, Veres reported his discomfort upon hearing several Austrians talk about the OMV-MOL merger as a foregone conclusion in light of the historical Austro-Hungarian Empire. Veres expressed concern about EU regulations that prohibit U.S.-style restrictions on investment in strategic industries.

4.(C) In this light, Veres welcomed and requests USG technical assistance to help develop a Hungarian framework to address these concerns. We strongly support Hungary's request in this area and encourage a State/EB or Treasury team to visit Hungary and provide this support as soon as practical.

EU Deficit Concerns

5.(C) Veres beamed when discussing the July 10 European Union Council, Economic and Financial Affairs (ECOFIN) decision to accept actions Hungary has taken to reduce its budget deficit

(Ref A; Ref B), as Hungary remains subject to the European Union Excessive Deficit Procedure. In a mix of fraternal concern and national pride, he described a somber Czech Minister of Finance, whose government supports the reforms necessary to reduce their budget deficit, after ECOFIN at the same July 10 meeting found that the Czech Republic failed to comply with a Council recommendation to reduce their deficit. According to Veres, the Czech minority government will likely not be able to pass measures to fulfill deficit-cutting requests, so the Czech Minister of Finance is likely to resign in protest this fall.

Tax and Health Reforms Highlight Coalition Differences

6.(C) Going into fall, which Veres describes as a sensitive final period of implementing "painful" reforms, he sees tax and health insurance reforms as flashpoints in discussions between ruling MSZP and junior coalition partner SzDSz. On health insurance, although the main budget targets are not likely to change, the details of how the system will be implemented are still under discussion, with SzDSz pushing for greater privatization than their Socialist partners. On taxation, SzDSz is pushing for business-friendly tax simplification and reduction while MSZP is taking a more measured approach. Veres expects a comprehensive tax reform roadmap to be ready by January 1, 2008; and for tax cuts to be implemented January 1, 2009 and January 1, 2010. On repeal of the very unpopular with business solidarity tax, State Secretary Almos Kovacs tellingly joked this would happen only "in the promised land." Rather, tax simplification could result in rate reduction or even elimination of more complex taxation categories; the solidarity tax itself would not be repealed, but reduced in ¶2010. Veres and Kovacs both support a multi-year predictable tax scheme for business, and that is why they are using 2008

as a planning year. This extends to property tax, where they plan to conduct assessments during 2008 before a 2009 rollout.

Pain: Education and Local Government Reforms; Subsidy Cuts

7.(C) On perceptions that Hungary's reforms have been overly revenue-oriented, Veres insisted that their deficit reduction program relied two-thirds on spending cuts and one-third on revenue measures. This will become clear, perhaps alarmingly so, as teachers will begin to assume a higher course load this fall, and local governments grapple with sharply reduced central government funding for their programs. In this way, the government can shrink spending on local government without cutting positions or institutions, both of which would require a nearly impossible two-thirds majority vote in a highly divided Parliament. Against this backdrop, the coalition would like to reduce the income ceiling for receipt of natural gas subsidies by twenty to thirty thousand forints a month, down from the current 94,000 ceiling, which covers roughly two-thirds of households in Hungary (Veres asked that we specifically keep this proposal close hold). Aware of negative polling numbers, Veres commented that MSZP and SzDSz are united in one thing: they don't want to do anything further that is "unpopular with the population."

Reports of MSZP Infighting are Overstated

8.(C) Veres chuckled when discussing the suggestion that a government reshuffle that elevated erstwhile PM Gyurscany rival Peter Kiss to Cabinet Minister, asserting that PM Gyurscany has cannily developed a consensus in the Socialist party. MSZP county leaders consulted on the government changes and broader reforms, and they "know how to handle the situation" from the top on down. Rather than being a rival, Veres recalls Kiss as being right "in the kitchen with Gyurscany" as the current reforms were being developed. As Veres put it, only Gyurscany knows what intrigues lurk in the government, but from his eye-witness perspective as Socialist insider, he saw the recent reshuffle as the product of a

unified party rather than an attempt to coopt rivals.

Inflation; Growth; Transparency Affects of Tax Enforcement

9.(C) One of the stunning and unexpectedly positive aspects of the reform program has been an increase in tax revenues, and Veres supported his claim that this has "whitened" the economy through dramatic increases in the rolls of taxpaying workers in construction, catering, and other specialties associated with side payments and off-the-books employment. For this reason, both Veres and Kovacs discounted wage growth as inflationary - the pay is just now becoming official. Veres discounted market-surprising reports of a jump to 8.6 per cent year-on-year inflation in June (Ref A), saying that inflation pressures through August were part of the government's projections, but that everyone has already become comfortable with the truly surprising fact, the speed of the deficit reduction, particularly its growth-limiting aspects. Recent Constitutional Court decisions forcing the government to pay up to a half percent of GDP in additional pension payments make Veres reluctant to speculate on a deficit figure better than 6.5 per cent of GDP this year (despite optimistic comments by SzDSz president and Economy Minister Koka). He will let Gyurcsany speculate about GDP growth as high as three per cent this year, but officially expects it to reach at least 2.5 per cent. This early recovery towards growth leads Veres to optimism about a sharp decline in inflation this August, and a complete recovery from the negative affects of the fiscal adjustment by the end of 2008, with growth around four per cent in 2009.
FOLEY